No. 77-1559

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In the Supreme Court of the United States

OCTOBER TERM, 1977

UNION MUTUAL LIFE INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinion of the district court (Pet. App. A, pp. 1-66) is reported at 420 F. Supp. 1181. The opinion of the court of appeals (Pet. App. B, pp. 74-108) is reported at 570 F. 2d 382.

JURISDICTION

The judgment of the court of appeals was entered on February 1, 1978. The petition for a writ of certiorari was filed on May 1, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a life insurance company's reserves for "unearned premiums" on noncancellable health and

accident insurance policies are includable in its "life insurance reserves" under Section 801(b) of the Internal Revenue Code of 1954.

2. Whether annual interest that is payable in advance on life insurance policy loans is includable in a life insurance company's "gross investment income" under Section 804(b)(1) of the Internal Revenue Code of 1954 at the time it is due and the company either receives the interest or adds it to the principal balance of the loan.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

Section 801 [as added and amended by Section 2(a), Life Insurance Company Income Tax Act of 1959, Pub. L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.

* * * * *

(b) *Life Insurance Reserves Defined.*—

(1) *In general.*—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

* * * * *

Section 804 [as added and amended by Section 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. TAXABLE INVESTMENT INCOME.

* * * * *

(b) *Gross Investment Income.*—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) *Interest, etc.*—The gross amount of income from—

(A) interest, dividends, rents, and royalties,

* * * * *

Section 818 [as added and amended by Section 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. ACCOUNTING PROVISIONS.

(a) *Method of Accounting.*—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual

statement approved by the National Association of Insurance Commissioners.

* * * * *

STATEMENT

1. *Unearned premiums reserve issue.*

Petitioner is a mutual life insurance company which issues various types of insurance, including "noncancellable" health and accident insurance policies. Unlike "cancellable" health and accident policies, "noncancellable" policies may not be cancelled by the company as long as the policy holder pays the required annual premiums.[1] These annual premiums remain level over the stated life of the policy (Pet. App. A, pp. 1, 50).

The premiums on noncancellable health and accident policies are generally payable annually and in advance of the period of coverage to which they apply. These premiums are treated as earned ratably over the period of coverage. Thus, at any particular time, the pro rata portion of the gross annual premium received by the company that is attributable to the unexpired portion of the policy year is considered to be "unearned." The aggregate amount of "unearned" premiums as of the end of the calendar year is reflected as a reserve for "unearned premiums" on the company's annual statement. That statement must be filed, in accordance with procedures established by the National Association of Insurance Commissioners (N.A.I.C.), with the insurance departments of the various states in which the company does business (Pet. App. A, p. 50).

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[1]Under Treasury Regulations on Income Tax (1954 Code), Section 1.801-3(c) (26 C.F.R.), a health and accident policy will qualify as a "noncancellable" policy for federal income tax purposes only if the company is obligated to continue or to renew the policy at specified premiums at least until the policyholder attains the age 60.

The reserve for "unearned premiums" is determined and maintained in essentially the same manner for both noncancellable policies and cancellable policies. However, an additional reserve must be maintained and separately stated on the N.A.I.C. annual statement with respect to noncancellable health and accident policies representing the company's obligation to provide continued insurance coverage in future policy years at the same level annual premium, even though the risk of morbidity increases as the policyholder grows older. The actuarially determined amount that the company must hold, at the end of the policy year, to meet these increased insurance costs in excess of premiums in subsequent policy years is called the "terminal" reserve. The terminal reserve represents the excess of the present value of projected future benefits over the present value of future premiums. The additional reserve on the N.A.I.C. annual statement for noncancellable health and accident policies as of the end of the calendar year reflects the average of the terminal reserve for the current policy year and the terminal reserve for the prior policy year. It is therefore called the "mid-terminal" reserve (Pet. App. A, p. 50).

Net additions to both the reserve for "unearned premiums" and the mid-terminal reserve are deductible by the company in the computation of its "gain from operations" under Section 809(d)(2) of the Internal Revenue Code of 1954 (26 U.S.C.). The mid-terminal reserve also qualifies for inclusion in the company's total "life insurance reserves" under Section 801(b) and is therefore taken into account in the determination of the exclusion of the "policyholders' share of investment yield" in the computation of the company's "taxable investment income" under Sections 804 and 805 of the Code.

On its income tax returns for 1958-1968, petitioner included a portion of its "unearned premiums" in its "life

insurance reserves," thereby increasing the amount of the tax exclusion for the policyholders' share of its investment yield.[2] On audit, the Commissioner eliminated petitioner's "unearned premiums" from its "life insurance reserves," which resulted in an increase in petitioner's "taxable investment income" (Pet. App. A, p. 51).

After paying the additional taxes assessed, petitioner brought this refund suit in the United States District Court for the District of Maine. The district court upheld the Commissioner. After examining the pertinent legislative history, it concluded that Congress intended that only the mid-terminal reserve on noncancellable health and accident policies would be includable in "life insurance reeserves" for income tax purposes (Pet. App. A, pp. 51-59). The court of appeals affirmed (Pet. App. B, pp. 83-88).

2. *Policy loan interest issue.*

Petitioner also issues conventional life insurance policies under which the policyholder has the right to borrow against the cash value of the policy. Under the terms of the policies, interest at a specified annual rate for the remaining portion of the policy year is payable in advance at the time the policy loan is made. Thereafter, interest for each policy year is payable in advance on each succeeding policy anniversary date as long as the loan remains outstanding. Petitioner bills the policyholder for

[2]As we have noted (p. 4, *supra*), the reserve for "unearned premiums" as shown on the N.A.I.C. annual statement reflects the pro rata portion of the gross annual premiums that is attributable to the remaining periods of unexpired coverage as of the end of the calendar year. On its tax returns, petitioner reduced these reserves for gross unearned premiums to amounts based on "net" unearned premiums— *i.e.*, gross annual premiums reduced by the "loading" element covering administrative expenses, commissions, unforeseen contingencies and profit.

the advance interest, and, if the policyholder fails to pay it in cash on the due date, petitioner adds the interest to the principal balance of the loan. Generally, the advance interest for the first partial year of the loan is not paid in cash, but is charged against the cash value of the policy. The annual advance interest charges for subsequent years are paid in cash by the policyholders in about half of the loans. Otherwise, petitioner adds the interest charges to the principal loan balances (Pet. App. A, pp. 14-15).

Some of petitioner's policies also provide for the payment of annual premiums as they fall due through the use of "automatic premium loans" against the cash value of the policy. The interest on these premium loans is also payable annually and in advance, and, like the premiums themselves, is automatically added to the balance of the policy loan (Pet. App. A, pp. 14-15). In the event a policy loan of either type is not repaid, the amount of the loan is deducted from any benefits paid or from the cash value if the policy is surrendered. If the policy is surrendered or matures during a period for which interest has been paid in advance or charged against the cash value, the policyholder or beneficiary is given credit for that portion of the interest that is allocable to the remainder of the policy year (Pet. App. A, pp. 15-16).

On its annual statements, petitioner reflected the advance interest allocable to periods after the end of the calendar year as "unearned" income. It therefore included the advance interest in the assets (whether received in cash or added to the principal balances of the policy loans), and recognized an offsetting liability in the amount of the interest allocable to periods after the end of the calendar year. Similarly, in its computation of "gross investment income," petitioner reduced the interest "collected during the year" by the amount of "unearned" interest income

(Pet. App. A, p. 16; R. 174-175, 179).[3] See Noback, *Life Insurance & Accounting* 214, 227, 319 (1969).

On its income tax returns for the years in question, petitioner excluded the advance interest allocable to the remainder of the policy year from its "gross investment income" under Section 804(b)(1) of the Code. On audit, the Commissioner included all policy loan interest received or charged against the cash value of the policies in petitioner's "gross investment income." The district court upheld the Commissioner's determination. It ruled, in accord with *Franklin Life Insurance Co.* v. *United States*, 399 F. 2d 757, 761-763 (C.A. 7), certiorari denied, 393 U.S. 1118, and *Jefferson Standard Life Insurance Co.* v. *United States*, 408 F. 2d 842, 856-857 (C.A. 4), certiorari denied, 396 U.S. 828, that interest payable in advance on policy loans is fully includable in gross investment income (Pet. App. A, pp. 17-23). The court of appeals affirmed. Like the district court, it followed the decisions of the Seventh and Fourth Circuits, and further observed that the subsequent opinion of the Fifth Circuit in *Southwestern Life Insurance Co.* v. *United States*, 560 F. 2d 627, certiorari denied, April 24, 1978 (No. 77-1124), was to the same effect (Pet. App. B, pp. 78-83).

ARGUMENT

1. *Unearned premiums reserve issue.*

a. The decision below correctly held with respect to this question of first impression that "unearned premiums" on noncancellable health and accident insurance may not be included in a life insurance company's "life insurance reserves" under Section 801(b) of the Code.

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[3]"R." refers to the three-volume record appendix filed in the court of appeals.

Under the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, one of the components of a company's taxable income is its "taxable investment income." See Sections 802(b) and 804 of the Code. A company's total investment income is regarded as including a share for the company, which is taxable, and a "policyholders' share," which is excluded from the tax base. The policyholders' share is determined by the ratio of the company's life insurance reserves to its assets so that an increase in life insurance reserves will reduce the company's taxable investment income. See *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U.S. 148, 155-156; Sections 804 and 805.

The statutory provisions defining life insurance reserves have their origin in the Revenue Act of 1942, 56 Stat. 798. At that time, Congress adopted a special definition of the term "life insurance reserves" for purposes of computing the exclusion for the policyholders' share of investment income. While Section 163 of the Revenue Act of 1942 retained the "required by law" standard of prior law, it narrowed the definition of reserves to those "amounts which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts * * *." See Section 201(c)(2) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.), as amended by Section 163 of the Revenue Act of 1942.[4]

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[4]Prior to the 1942 amendment, the statute permitted a deduction from investment income equal to a specified percentage of "reserve funds required by law." See Section 203(a)(2) of the 1939 Code. Since the statute did not distinguish between "life insurance reserves" and other "reserve funds required by law," both the "unearned premiums" and the additional mid-terminal reserve with respect to noncancellable accident and health insurance were held to qualify for the percentage reduction from gross investment income. *Commissioner* v. *Monarch Life Ins. Co.*, 114 F. 2d 314 (C.A. 1).

The committee reports accompanying the 1942 legislation show that Congress was willing to permit certain non-life insurance reserves to be added to life insurance reserves for purposes of determining whether the company qualified as a life insurance company under the 50-percent reserve ratio test. See *United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725; Section 801(a). However, the legislative history further shows that Congress simultaneously intended to establish a more stringent test for determining whether a reserve qualified for computation of the exclusion for the policyholders' share of income. Thus, the House Committee observed that while the "pro rata unearned premiums * * * on noncancelable [sic] health and accident policies are added to life insurance reserves in determining whether a company is to be considered a life insurance company," the life insurance reserves themselves would include, in the case of noncancellable health and accident policies, only "those amounts which must be reserved, in addition to pro rata unearned premiums, to provide for the additional cost of carrying such policies in later years when the insured will be older and subject to greater risk and when the cost of carrying the risk will be greater than the premiums then being received." H.R. Rep. No. 2333, 77th Cong., 2d Sess. 109 (1942). The Senate Report likewise states that the "unearned premiums" with respect to noncancellable health and accident policies will be taken into account under the amended provisions "for purposes of the definition of a life insurance company only." S. Rep. No. 1631, 77th Cong., 2d Sess. 144 (1942).

In light of the legislative history, the decision below properly concluded that the 1942 amendments were intended to qualify only the additional mid-terminal reserve on noncancellable health and accident policies as "life insurance reserves" for purposes of Section 801(b). Indeed, as both courts below suggested (Pet. App. A, p. 58; Pet. App. B, p. 87), there would have been no reason

for Congress to distinguish between pro rata unearned premiums on cancellable policies and those of non-cancellable policies. The only characteristic of non-cancellable health and accident insurance that made it appropriate to bring such policies within the scope of the life insurance provisions was that noncancellable policies, like ordinary level premium life insurance policies, "require the accumulation of substantial reserves against increased future risks" (H.R. Rep. No. 2333, *supra*, at 109). Since it is only the additional, mid-terminal reserve, and not the reserve for pro rata unearned premiums, that serves to measure the funds that will be required to cover the "increased future risks" to be incurred when projected benefits will be greater than the level premiums, only the mid-terminal reserve can qualify as a "life insurance reserve" under Section 801(b).

b. Moreover, the language of Section 801(b)(1) precludes the unearned premium reserve from qualifying as "life insurance reserves" for purposes of computing the exclusion for the policyholders' share of investment income. Under Section 801(b)(1)(A), a life insurance reserve must be based on "recognized mortality or morbidity tables and assumed rates of interests." But the reserve for "unearned premiums" is computed simply on the basis of the pro rata portion of the gross annual policy premium that is allocable to the remaining period of unexpired coverage. It bears no relation to recognized mortality or morbidity tables.

Given the clear statutory language, petitioner has never directly contended that the unearned premium reserve as reflected in its annual statements would satisfy the

requirements of Section 801(b).[5] However, in order to circumvent the statutory requirement that a life insurance reserve be computed on the basis of recognized mortality or morbidity tables and assumed rates of interest, petitioner has computed an amount which, given an assumed interest rate, would be required to pay its actuarially projected claims for the remainder of the policy year. In petitioner's view (Pet. 11), this self-designated reserve for unearned "net" premiums qualifies as part of its "life insurance reserves" because it is determined on the basis of an assumed rate of interest. But in providing for computation on the basis of "recognized" mortality or morbidity tables, Section 801 and its statutory predecessors premise qualification upon compliance with established practices in the computation of reserves for annual statement purposes. The decision below therefore properly rejected petitioner's abstract hybrid computation.[6]

2. *Policy loan interest issue.*

a. The decision below also correctly held that the interest petitioner charges in advance on policy loans must be included in its income at the time it is due and

[5]Cf. *Central National Life Insurance Co.* v. *United States*, Ct. Cl., No. 194-70, decided April 19, 1978. There, it was found that the taxpayer had established that a reserve for unearned premiums on credit life insurance reasonably approximated the amount that would have been computed on a strictly tabular basis and that would have qualified for inclusion in "life insurance reserves" under the statute.

[6]Petitioner further argues (Pet. 12) that the question whether unearned premium reserves for noncancellable health and accident insurance qualify as life insurance reserves is important to the entire life insurance industry. But this the only case in which the issue has been litigated since the current statutory provisions were enacted in 1942.

petitioner either receives it in cash or charges it against the cash value of the policy. In so holding, the decision is in accord with those of three other circuits that have rejected the claim that such interest can be deferred for tax purposes until the expiration of the period for which the interest is charged (Pet. App. B, pp. 79-81). *Franklin Life Insurance Co.* v. *United States*, 399 F. 2d 757, 760-763 (C.A. 7), certiorari denied, 393 U.S. 1118; *Jefferson Standard Life Insurance Co.* v. *United States*, 408 F. 2d 842, 856-857 (C.A. 4), certiorari denied, 396 U.S. 828; *Southwestern Life Insurance Co.* v. *United States*, 560 F. 2d 627, 641-642 (C.A. 5), certiorari denied, April 24, 1978 (No. 77-1124).[7]

As accrual basis taxpayers (see Section 818(a) of the Code), life insurance companies are subject to the controlling principle that income must be reported "[w]hen the right to receive an amount becomes fixed" (*Spring City Co.* v. *Commissioner*, 292 U.S. 182, 184), *i.e.*, when the item becomes "due and payable" (*Schlude* v. *Commissioner*, 372 U.S. 128, 137). See also Treasury Regulations on Income Tax (1954 Code), Sections 1.446-1(c)(ii) and 1.451-1(a) (26 C.F.R.).

Here, the terms of petitioner's policies provided that the interest on policy loans is due and payable in advance. If the policyholder failed to pay the interest as due, it was charged directly against the cash surrender value of the policy, *i.e.*, the fund invested and held by petitioner for the benefit of the policyholder. In these circumstances, the decision below properly concluded that petitioner was required to accrue the advance interest at the time it was due and either collected in cash or charged against the cash value of the policy. While petitioner complains (Pet.

[7]The petition for a writ of certiorari in *Southwestern Life* did not seek review of the ruling on the advance interest issue. The question was presented, however, by the petitions filed in *Franklin Life* and *Jefferson Standard Life*.

15) that the accrual of advance interest distorts its income, the plain fact is that "[w]hen received, * * * [petitioner's] right to * * * [the interest] was absolute. It was under no restriction, contractual or otherwise, as to its disposition, use or enjoyment." *Brown* v. *Helvering*, 291 U.S. 193, 199.

b. Despite the uniform rejection of its position by the four circuits that have considered the question, petitioner urges (Pet. 16-17) that review by this Court is necessary in order to clarify the "disagreement and uncertainty" caused by the Court's decisions in *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180; *American Automobile Association* v. *United States*, 367 U.S. 687; and *Schlude* v. *Commissioner*, 372 U.S. 128. In each of those cases, the Court refused to permit tax deferral of advance payments in exchange for the performance of future services.

The lower courts have expressed various views as to the extent to which this Court's decisions preclude deferral of advance payments for services.[8] But that question is not presented here since the advance payments in this case were not tied to the performance of future services. To the contrary, once petitioner loaned funds to a policyholder on the security of the cash value of the policy, it was under no obligation to perform any services or incur additional expenses during the future period to which it seeks to defer the advance interest charges. As the court of appeals observed (Pet. App. B, p. 83 n. 2), the advance

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[8]Compare *New England Tank Industries, Inc.* v. *Commissioner*, 50 T.C. 771, affirmed, 413 F. 2d 1038 (C.A. 1), *Hagen Advertising Displays, Inc.* v. *Commissioner*, 407 F. 2d 1105 (C.A. 6), and *Mooney Aircraft, Inc.* v. *United States*, 420 F. 2d 400 (C.A. 5), with *Artnell Co.* v. *Commissioner*, 400 F. 2d 981 (C.A. 7), and *Boise Cascade Corp.* v. *United States*, 530 F. 2d 1367 (Ct. Cl.), discussed at p. 15, n. 9, *infra*. See also Rev. Proc. 71-21, 1971-2 Cum. Bull. 549.

interest charges are analogous to prepaid rent, which has been held to be accruable in the year of payment. *United States* v. *Williams*, 395 F. 2d 508 (C.A. 5). *Artnell Co.* v. *Commissioner*, 400 F. 2d 981 (C.A. 7), and *Boise Cascade Corp.* v. *United States*, 530 F. 2d 1367 (Ct. Cl.), upon which petitioner relies (Pet. 16-17), are therefore distinguishable. Those cases involved advance payments for future services and turned on considerations of matching related revenues and expenses.[9]

c. Petitioner further argues (Pet. 18-19) that the decision below conflicts with *Commissioner* v. *Standard Life & Accident Insurance Co.*, *supra*. There, the Court held that unpaid premiums must be reflected in the computation of a life insurance tax liability "in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners" (see Section 818(a); 433 U.S. 148). It therefore approved the inclusion of the net valuation portion of unpaid premiums in reserves, assets, and gross premium income. Since petitioner's deferral of

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[9]*Artnell* arose in the context of a corporate reorganization involving a professional baseball club. The question presented was whether the liquidated corporation should have accrued the prepaid revenues received with respect to future baseball games to be played by the successor corporation. The Seventh Circuit concluded that the Tax Court had erred in refusing to consider the factual details of the taxpayer's deferral method of reporting such income, and remanded for the Tax Court to consider the merits of that method and to determine whether the Commissioner had abused his discretion in rejecting that method (see 400 F. 2d at 984-985).

Boise Cascade involved contracts for engineering, construction, architectural and consulting services requiring, in certain instances, payment to be made prior to the period in which the services were to be performed. The court concluded that deferral was appropriate as a means of "accurately matching costs and revenues" (530 F. 2d at 1377). In reaching this conclusion, however, the court stated that the fact that a deferral method was in accord with generally accepted accounting principles was not a controlling consideration for tax purposes (see 530 F. 2d at 1372).

advance interest is consistent with N.A.I.C. annual statement reporting, it urges that Section 818(a) requires a similar result for tax purposes.

But the Court in *Standard Life* did not hold that the N.A.I.C. method of accounting governs all tax computations of life insurance companies. As the Court there observed, "[t]he legislative history [of Section 818(a)] makes it clear that the accounting procedures established by the N.A.I.C. apply if they are 'not inconsistent' with accrual accounting rules. In other words, except when the rules of accrual accounting dictate a contrary result, N.A.I.C. procedures 'shall' apply" (433 U.S. at 158-159; footnotes omitted). Since the general rules of accrual accounting did not speak to the question of the fictional assumptions dealing with unpaid premiums, the Court concluded that Section 818(a) "require[d] use of the NAIC approach to fill the gap" (*id.* at 162; footnote omitted).

Here, however, the general rules of accrual accounting do speak to the question of the treatment of advance interest. As we have pointed out *supra*, pp. 13-14, they provide that such interest is includable in income when received and cannot be deferred to the period for which the interest is charged. The N.A.I.C. method of accounting is therefore inapplicable to the reporting of advance interest for tax purposes.

d. Finally, petitioner contends (Pet. 19-20) that deferral is proper at least with respect to that portion of the advance interest that it added to the principal balances of the policy loans. This argument has likewise been rejected by the four courts of appeals that have considered the question. However, petitioner (Pet. 20) relies upon *Bankers Union Life Ins. Co.* v. *Commissioner*, 62 T.C. 661, in which the Tax Court accepted the argument that such "capitalized" or "add-on" interest need not be taken into income until "earned."

A conflict between the Tax Court and the courts of appeals is not a conflict of decisions requiring resolution by this Court. At all events, the Tax Court's decision rests upon an erroneous analogy between a life insurance policy loan and a common loan on which interest is discounted. As the Seventh Circuit in *Franklin Life* (399 F. 2d at 763) and the court below (Pet. App. B, p. 82) noted, unlike an ordinary discount loan, the advance interest on a life insurance policy loan does not represent sums that may never be received by the company. Since the total principal balance (including interest added) cannot exceed the cash surrender value of the policy, there is no doubt that the company will collect the interest. There is accordingly no basis for the deferral of the portion of the advance interest added to the principal balances of the policy loans.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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